Supreme Court of the United States,

OCTOBER TERM, 1920.

No. 663.

DAVID M. GOODRICH,

Plaintiff in error,

vs.

WILLIAM H. EDWARDS, United States Collector of Internal Revenue for the Second District of the State of New York.

ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

REPLY BRIEF FOR PLAINTIFF IN ERROR.

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I.

In considering the Income Tax Laws of the Civil War period as well as the Income Tax Act of August 28, 1894 (28 Stat. 509, c. 349, secs. 27 to 37), it must be borne in mind that these several statutes imposed not only taxes upon incomes derived from investments in real estate and personal property but also excise taxes on "any profession, trade, employment, or vocation carried on in the United States or elsewhere." It should further be borne in mind that a tax upon the *entire* proceeds of all sales of real or personal property of individuals not engaged in trade or business would be a direct property tax and not an excise (*Nicol* v. *Ames*, 173 U. S. 509, 521), whilst a tax on the carrying on of trade or business measured by the gross receipts resulting from all sales made in such trade or business would be a constitutional and valid

excise tax. *Pacific Insurance Co.* v. *Soule*, 7 Wall. 433; *Spreckels Sugar Refining Co.* v. *McClain*, 192 U. S. 397, and *Flint* v. *Stone Tracy Co.*, 220 U. S. 107.

The tax levied by the Act of August 5, 1861 (12 Stat. 292, 309) was limited to "income". The more comprehensive phrase "gains, profits, or income" originated in the Act of July 1, 1862 (12 Stat. 473, c. 119) and was also employed in the Act of 1864 (13 Stat. 281, c. 173). The term "gains, profits *or* income" so introduced in the Act of 1862, became "gains, profits *and* income" in the Act of 1865 (13 Stat. 479, c. 78), and this formula was thereafter followed. The words "gains" and "profits" thus added in and by the Act of 1862 were presumably intended to add something to the scope and effect of the statute as theretofore worded. *Pennington* v. *Coxe*, 2 Cr. 33, 59. Obviously, if the term "income" had then been understood by Congress to include all gains and profits, no amendment would have been necessary. On the contrary, it is reasonable and logical to infer that, in adding the words "gains" and "profits", Congress meant to include something materially additional, and thereby to reach and tax gains or profits which would not necessarily be included within the scope of the term "income."

The idea of a differentiation between gains and profits resulting from trades or businesses and income resulting from investments in real and personal property may have been in the mind of the court in *Pollock* v. *Farmers Loan & Trust Co.*, 157 U. S. 429; rehearing 158 U. S. 601 at p. 635, for Mr. Chief Justice Fuller then used the following language in reference to the Income Tax Act of 1894:

> "We have considered the act only in respect of the tax on income derived from real estate, and from invested personal property, and have not commented on so much of it as bears on gains or profits from business, privileges, or employments, in view of the instances in which taxation on business, privileges, or employments has assumed the guise of an excise tax and been sustained as such."

Moreover, when the Sixteenth Amendment was formulated and submitted to the state legislatures for ratification the settled taxing formula had long been "gains, profits and income", and if it had been then intended by Congress to include all gains and profits resulting from the ownership of real and personal property, surely the form so long in use would naturally have been followed and the language not limited to "incomes". Indeed, less than a year prior to the submission to the state legislatures of the Sixteenth Amendment, Senator Owen introduced a joint resolution providing that—

> "The Congress shall have power to provide for the collection of a uniform tax upon the gains, profits and income received by every citizen or person of the United States, including every corporation, association, or company doing business for profit in the United States, subject to such exemption as it may deem proper." (Cong. Rec., May 1, 1908, p. 5514.)

In the *Pollock* case, it was not contended by counsel for the taxpayer that a tax levied by Congress on gains and profits derived from the carrying on of businesses, privileges, employments, or vocations would be a direct tax. The essential difference between such an excise tax and a tax levied on income derived from investments in real estate and personal property was recognized and consistently urged throughout the argument in distin-

guishing the prior cases, such as *Pacific Insurance Co.* v. *Soule*, 7 Wall. 433. This distinction was clearly confirmed by the court, and it has been reiterated by it in subsequent cases; e. g., *Spreckels Sugar Refining Co.* v. *McClain*, 192 U. S. 397, 411, 412, and *Flint* v. *Stone Tracy Co.*, 220 U. S. 107, 148.

In the brief now filed on behalf of the Government, comment is made upon the fact that the counsel in the *Pollock* case, in challenging the constitutionality of the Act of 1894, did not urge the contention now advanced, and it is suggested that apparently the point was not even thought of; but this assumption is hardly warranted by the record in that case.

The attention of the court was expressly called to the provision of the Act of 1894 which taxed "profits made upon the sale of land if purchased within two years" (157 U. S. at p. 444). The point was not then particularly urged because the controversy before the court did not involve any question whatever as to profits realized from the sale or conversion of investments in real or personal property. A perusal of the record will readily show this.

As to the rulings and decisions of the Treasury Department, it may suffice to point out that those prior to 1872 were not approved or followed in *Gray* v. *Darlington*, 15 Wall. 63, as shown in the plaintiff's main brief, and that those since 1913 are hardly entitled to be regarded as persuasive or authoritative in view of the repeated adjudications of this court overruling erroneous interpretations and assessments by the Commissioner of Internal Revenue under the Act of 1909. Indeed, in the brief now filed on behalf of the Government, it is stated (at p. 60) by the learned Solicitor General that after a

careful study of the Act of 1916 he is forced to the conclusion that the Commissioner of Internal Revenue has erroneously construed it in a very important respect materially affecting the rights of taxpayers. This erroneous construction has been insisted upon and applied uniformly by the Government during the past four years and large sums have been illegally collected thereunder.

Nor are the few and fugitive examples of state income taxes of any help. In state taxing legislation the present question is of no practical importance, and the difference between a direct and an indirect tax or excise, a property and an income tax, is of no particular constitutional significance. Under our state constitutions, it is immaterial what the incidences or measure of a tax may be, and it matters not whether a tax be a property tax, as distinguished from an income tax proper, or *vice versa*. In either aspect the power is not qualified by any such limitation as the Federal Constitution imposes on direct taxes. But in the case of a federal tax, the difference is controlling and decisive, for if the tax is in essence and effect a direct tax on property, as distinguished from a tax on incomes, it must be apportioned.

If what is essentially a direct tax because it takes a substantial part of the proceeds of the sale of a capital asset, can be changed in its nature by merely defining it as a tax on income, then part of the very purpose of the Constitution can be readily defeated and set aside, and the constitutional limitation and protection embodied in the requirement of apportionment will have to be regarded as in great measure illusory and futile notwithstanding the recent emphatic declaration of this court in *Eisner* v. *Macomber*, 252 U. S. 189, 206, that—

> "A proper regard for its genesis, as well as its very clear language, requires also that this Amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overriden by Congress or disregarded by the courts."

It is submitted that the Sixteenth Amendment cannot be extended by loose construction beyond the clear import of the language or the subject matter of "incomes" specifically pointed out. *Gould* v. *Gould*, 245 U. S. 151, 153.

II.

The Government contends that the cases arising under the Corporation Excise Tax Act of 1909 necessarily involved a construction of the word "incomes" as used in the Sixteenth Amendment and that the word was used in that act "in exactly the same sense that it was used in the Sixteenth Amendment." This view is emphatically challenged by the plaintiff. It need only be repeated that the Act of 1909 was an excise tax and *not* a tax on incomes proper, and that the constitutional sense of the term "incomes" was not in any way involved because the measure of the corporation excise tax might have been receipts, gross or net, without affecting the validity of the statute as an excise tax. The court in the Corporation Excise Tax cases was called upon to do no more than determine the true intent and meaning of the language of the Act of 1909, and the result would have been exactly the same in each case if the

word "income" had not been used at all in the Act of 1909, but instead the words gains or profits, or net receipts had been employed. No question as to the intent and meaning of the constitutional term "taxes on incomes" as embodied in the Sixteenth Amendment was, therefore, presented for consideration or adjudication by the court. Stated in other words, had the Corporation Excise Tax of 1909 been measured by gross receipts, or the entire proceeds of the conversion of any capital assets into money, with or without profit, it would have been a valid excise tax and hence constitutional.

III.

In determining the true intent and meaning of the language "taxes on incomes" contained in the Sixteenth Amendment, the consequences of adopting the broad contention of the Government and holding, beyond the clear import of its language, that every increase of value in real estate and invested personal property when realized by sale or conversion becomes income now taxable without apportionment, must be duly weighed and appreciated. If it be now held that increase in value when so realized constitutes income within the Sixteenth Amendment, then constitutionally speaking there is no limit to the period or series of years during which the increase in value may have been accumulating or accruing. If the mere fact of sale or conversion can be logically held to change what was theretofore clearly capital into part capital and part income, then it matters not when the increased value accumulated or accrued, and Congress need make no concession whatever limiting the increase

to what accrued after the adoption of the amendment. It could then tax to an unlimited extent any increase realized by a taxpayer who had held property, real or personal, for many years, and could take, in a few years, it might well be, the greater part of all the accumulations of property in every State. The present annual tax, graduated up to 73 per cent, upon large incomes, demonstrates how readily and quickly most of the accumulated property of the citizens of the States might be then taken in federal taxes to the prejudice of the States and the impairment of their fiscal resources.

The vital importance of this question to the several States cannot be overstated, for it involves stupendous amounts of property investments and most of their present sources of taxation.

At all times during the thirty years preceding the ratification of the Sixteenth Amendment, the property values in the several States represented more or less recent increases or increment in value with corresponding increases in income. The appellant submits that it is highly improbable that in ratifying the Sixteenth Amendment the States contemplated and understood that the words "taxes on incomes, from whatever source derived," would operate to subject the greater part of the value of all the real estate or invested personal property within their limits to the unlimited taxing power of Congress. The extent of the property values which would thus be subjected to federal taxation without apportionment may be briefly reviewed.

The Census records report that the wealth of the United States increased from $43,642,000,000 in 1880 to $65,037,091,000 in 1890 and $187,739,071,000 in 1912;*

* Bulletin entitled "Estimated Valuation of National Wealth" published by the Department of Commerce, Bureau of the Census, in 1915.

that the assessed valuations of real property and improvements increased from $13,032,106,000 in 1880 to $18,956,556,000 in 1890 and $51,854,009,000 in 1912*, and that the money income of the United States increased from $7,382,340,000 in 1880 to $12,062,520,000 in 1890 and $30,481,920,000 in 1910.**

In determining these questions as to the taxing power of Congress, it is, of course, particularly fitting and proper to bear in mind the underlying theory and essential nature of our federal system, why the provisions limiting Congress to apportionment in respect of essentially direct taxes were adopted, and how vitally the interests of the States would be affected, if not prejudiced, and their taxing resources impaired by a ruling that every increase in value of real estate or invested personal property whenever realized by the owners thereof would be subject to the unlimited taxing power of the Federal Government exercisable by means or in the guise of a tax on incomes.

This aspect was pointed out by Mr. Chief Justice Fuller in the *Pollock* case as follows (158 U. S. at page 621):

> "The founders anticipated that the expenditures of the States, their counties, cities, and towns, would chiefly be met by direct taxation on accumulated property, while they expected that those of the Federal Government would be for the most part met by indirect taxes. And in order that the power of direct taxation by the general government should not be exercised, except on necessity; and, when the necessity arose, should be so exercised as to leave the States at liberty to discharge their respective obligations, and should

*Bulletin entitled "Wealth, Debt and Taxation" published by the Department of Commerce, Bureau of the Census, in 1915.

**Report of the Royal Statistical Society, London, of July, 1919. Estimates based upon publications of the Bureau of the Census, in 1912.

> not be so exercised, unfairly and discriminatingly, as to particular States or otherwise, by a mere majority vote, possibly of those whose constituents were intentionally not subjected to any part of the burden, the qualified grant was made. Those who made it knew that the power to tax involved the power to destroy, and that, in the language of Chief Justice Marshall in *McCulloch* v. *Maryland*, 'the only security against the abuse of this power is found in the structure of the government itself. In imposing a tax, the legislature acts upon its constituents. This is, in general, a sufficient security against erroneous and oppressive taxation.' 4 Wheat. 428. And they retained this security by providing that direct taxation and representation in the lower house of Congress should be adjusted on the same measure."

The security and protection which the States thus stipulated for in respect of direct taxes would be greatly impaired if it be now held that the increase in value of real or personal property in the States is subject to unlimited federal taxation by means of a tax on incomes. It is submitted that no such power was intended to be conferred by the phrase "taxes on incomes" as used in the Sixteenth Amendment, and that the intent and purpose of that Amendment can be fully and reasonably effectuated by limiting it to the current meaning and common understanding of the word income, namely, the usual and periodical return or benefit resulting from the ownership of real or personal property, which would not include the extraordinary, casual, or exceptional gain or profit realized from the conversion of a capital asset or investment into money.

Conclusion.

The Sixteenth Amendment and the Act of 1916 should, therefore, be construed as not applying to the increase in value of an investment in real or personal property realized upon the conversion of such investment into money in pursuance of isolated transactions not connected with the taxpayer's trade or business.

Washington, D. C., March 9, 1921.

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